

## NATIONAL FORECAST DESCRIPTION

### **The Forecast Period is the Second Quarter of 2008 through the Fourth Quarter of 2011**

The good news is most economists were wrong. Earlier this year, the consensus among most business cycle handicappers was the economy would slip into a recession in the first half of 2008. In our April 2008 *Idaho Economic Forecast* we reported real GDP would shrink at a 0.1% annual rate in the first quarter of this year followed by a 0.7% decline in the second quarter, which fits the rule-of-thumb definition of a recession. This forecast was made by Global Insight, Inc. based on a thorough evaluation of factors that would shape the economy's course. Given the threats of inflation, job losses, tight credit, the housing crises, the forecast of a U.S. recession seemed at the time to be almost a sure thing. Of course, there is no such thing as a sure thing (or free lunch). In its July 31, 2008 report, the U.S. Department of Commerce estimated real GDP actually grew at a 0.9% clip in this year's first quarter and 1.9% in its second quarter.

The bad news is positive real GDP growth during the first half of this year does not mean a recession has been avoided. Instead, it has been postponed. This prognosis reflects that many of the threats to the economy earlier this year remain. Granted, their impacts are likely to be offset in the third quarter by a temporary spike in consumer spending fueled by the tax rebate checks. However, the challenges facing the economy will remain after the checks are spent. As a result, the expected recession that failed to materialize earlier this year will appear at year's end. Real GDP is expected to retreat at a 1.7% annual rate in the fourth quarter of 2008 and decline 0.7% in the first quarter of 2009. On an annual basis, real GDP is forecast to advance just 1.6% this year and 0.9% next year—its slowest growth since 2001. Like the previous recession, the forecasted slowdown should be mild compared to other post-war slowdowns.

In fact things could be worse. A deeper economic downturn is explored in the Alternative Forecasts section of this publication. A summary of those findings is included here. It assumes the housing recession deepens even more than in the baseline and the price of oil shoots above \$160 per barrel this summer. Despite the effects of the stimulus package, real GDP tumbles. After the impact of the stimulative monetary and fiscal policies wear off, the economy contracts over two additional quarters. Peak to trough, real GDP shrinks 1.7% during these three quarters (2008:3 to 2009:1). Like the recessions of 1991 and 2001, this one is still mild compared with earlier postwar recessions. Unlike the past two recessions, however, the economy remains on the ropes longer and emerges from the downturn weaker, facing more troubles ahead. The good news is it is believed there is just a 20% chance of this happening.

Equally likely is things could go slightly better than expected. This could happen if stronger productivity gains, coupled with renewed optimism, facilitate enhanced business spending and a milder housing contraction. The stimulus package already in the pipeline adds fuel to the fire during the latter half of 2008. Combined with a stronger currency, the productivity gains also help to contain inflation. Foreign economic growth is also stronger, which helps boost U.S. exports and domestic manufacturing. As a result, real exports rise faster despite the stronger greenback. Finally, this scenario assumes energy prices are lower than in the baseline. Most notably, under these conditions, the economy avoids a recession.

Getting back to the original forecast, the economy is expected to remain sluggish through the first half of 2009. Real GDP is expected to pick up speed with abating negative factors. Inflation moderates. Hiring picks up. Credit becomes more available. And housing recovers. As a result, real GDP is projected to advance 3.6% in 2010 and 3.4% in 2011.

## SELECTED NATIONAL ECONOMIC INDICATORS

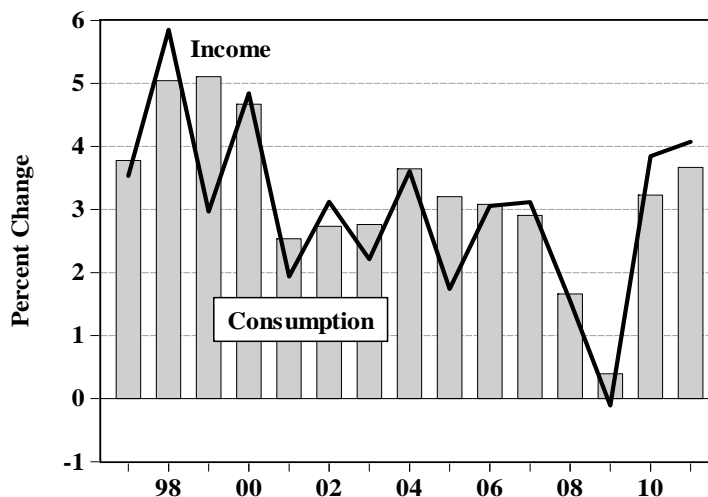
**Consumer Spending:** The salvo of negative economic news in recent months caused consumer confidence to sink earlier this year to its lowest level since 1992.

However, consumers' actual spending habits have been impacted less than their psyches. That is, real spending still managed to plod along at a 1.1% annual pace in this year's first quarter despite consumers' souring moods thanks to spending on services that expanded at a 3.1% clip. Other spending categories did not fare as well. The biggest hit was in durable goods, which retreated at a 6.0% pace. This decrease reflected huge declines in motor vehicle-related spending. Hardest hit was new light truck sales, which declined nearly 30% in the first quarter.

Unfortunately, truck sales are expected to significantly deteriorate throughout the year. Spending on nondurable goods

performed better; it was flat in the first quarter. However, some of its components were blasted by high energy prices. For example, real spending on gasoline and oil declined 5.1%. Fuel oil and coal spending retreated even further, dropping 20.1% in this year's first quarter. Total consumer spending is expected to grow faster beginning in the second quarter of this year, as consumers return to malls and big box stores with their federal tax rebate checks in hand. However, this will be a short shopping trip. Once the tax rebates are spent, real consumer spending is expected to recede. It should be pointed out that not all of this federal windfall will be spent like found money. Unfortunately, several factors suggest consumer confidence and spending will remain subdued over the near term. Most notably, home prices are expected to continue falling this year, taking real household net worth with it. Rising unemployment and rising inflation increase consumers' uneasiness about the future. Under these conditions, consumers are expected to hunker down and spend more in line with their means. As a result, consumer spending should advance just 2.2% annually over the forecast period, which is lower than the anticipated growth of real disposable income. One positive impact of slower consumer spending is it will allow households to improve their balance sheets. For example, after plunging 10.3% this year, real net worth should slowly recover from this drop by 2011.

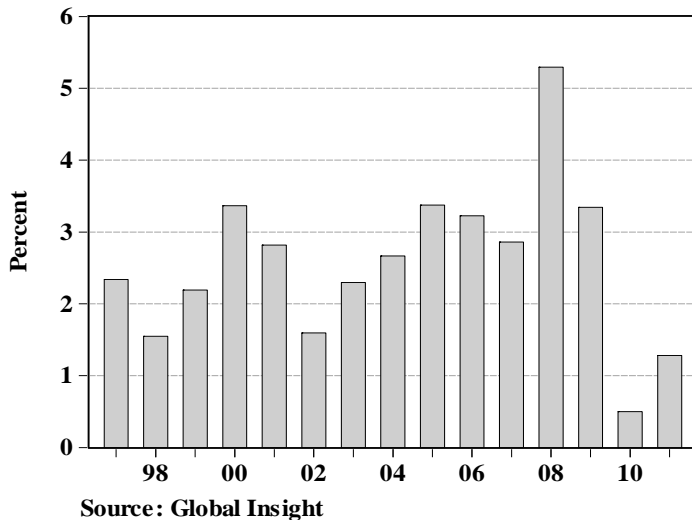
### U.S. Real Consumption and Disposable Income Growth



Source: Global Insight

**Inflation:** Fueled by soaring energy and food prices, headline inflation is expected to jump this year, but it will not approach the levels reached in the late 1970s and early 1980s. Similarities between then and now make it tempting to assume history will repeat itself. In the earlier inflation episode, rapidly rising oil prices caused the average retail gas price to more than double over three years, from 64 cents per gallon to a peak of \$1.37 per gallon. In comparison, the retail price of gasoline is expected to peak at \$4.57 per gallon later this year, which is 84.2% higher than it was three years ago. Food prices display a similar pattern. During the earlier period consumer food prices, as measured by the consumer price index (CPI), increase by about 30% over three years. However, this same measure advanced less than half as fast (14.0%) in the most recent three-year period. Thus, while both periods are marked with rising energy and food prices, they rose much more steeply in the late 1970s and early 1980s. These differences help explain why overall inflation has been lower recently. However, they do not explain all

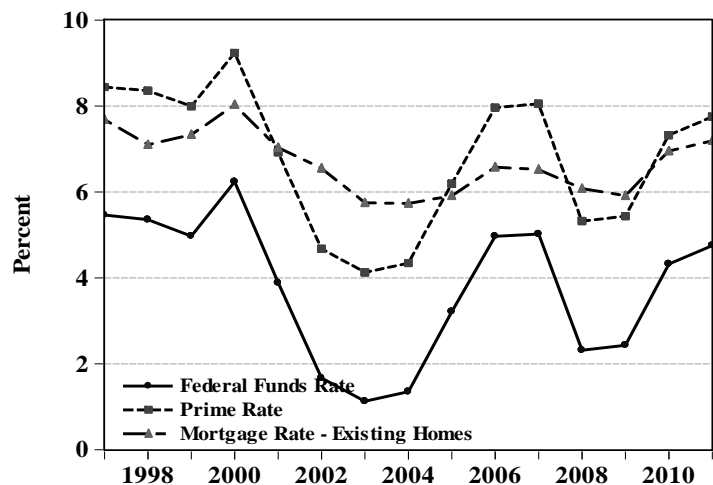
## Consumer Price Inflation



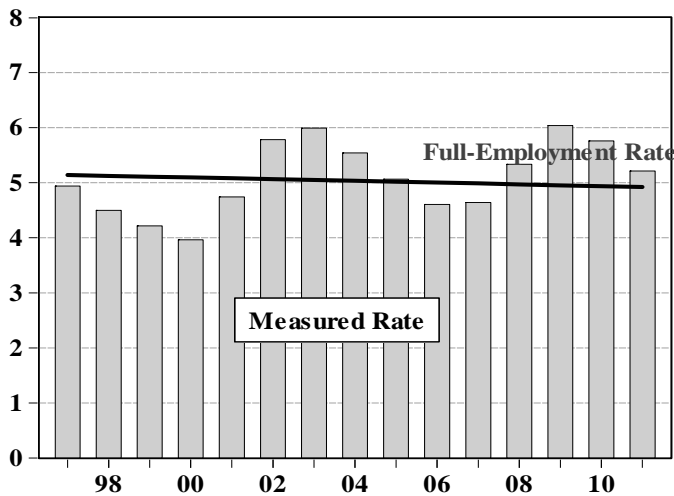
of the difference. During the late 1970s and early 1980s, employment expenses, as measured by unit labor costs, were advancing about 10% annually. More recently, they have been rising about 3% per year. This helps explain why total inflation is not roaring out of control and why it should not explode down the road. The reason for this is the U.S. labor market is expected to be relatively slack over the forecast period, so unit labor costs should be restrained. As a result, the core CPI rate—all items less energy and food—should average just 2.2% over the next few years. Overall consumer inflation is 5.3% this year, 3.3% next year, 0.5% in 2010, and 1.3% in 2011.

**Financial Markets:** As expected, the Federal Reserve's Federal Open Market Committee (FOMC) voted earlier this summer to keep its bellwether federal funds rate at 2.0% in light of rising inflation pressures. In its June 25, 2008 statement, the FOMC said, "The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help to promote moderate growth over time. Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased." The FOMC may have refocused its energies toward containing inflation, but it has not lost sight of promoting economic growth. The FOMC's June statement goes on to say, "The Committee will continue to monitor economic and financial developments and will act as needed to promote sustainable economic growth and price stability." Achieving this goal has grown more challenging recently, as the combination of rising inflation and slow economic growth have raised fears of stagflation. No one is anxious for this to occur because it took double-digit interest rates and a recession to remedy the country's last bout of stagflation. Fortunately, the economy's current condition is not at the point that requires such a drastic monetary policy. Instead, it appears the nation's central bank has entered a period of watchful waiting to see whether its previously enacted interest rate cuts have their desired effects. Once the FOMC is convinced the economy is back on solid ground, it will begin to inch up the federal funds rate to starve future inflationary pressures. The current forecast assumes the next federal funds interest rate increase takes place in the second quarter of next year and peaks at 4.75% in the last quarter of 2010 and remains there for the remaining quarters of the forecast. The outlook for the federal funds rate and other key interest rates are illustrated in the accompanying chart.

## Selected U.S. Interest Rates



## U.S. Civilian Unemployment Rate



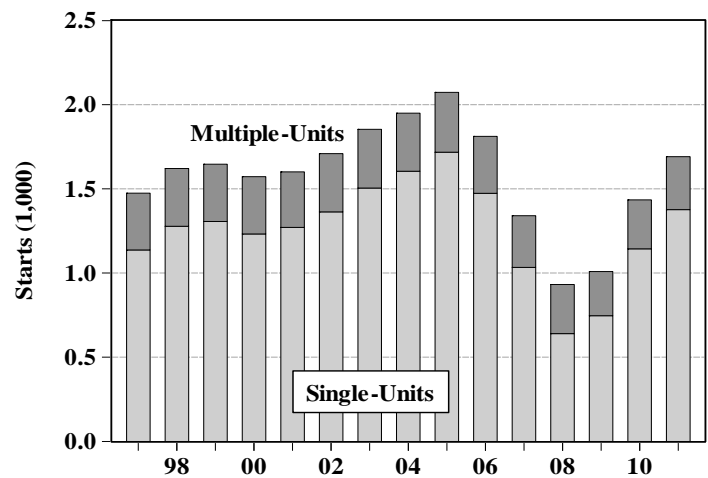
Source: Global Insight

**Employment:** The current labor market slump is just over a half year old. National nonfarm employment, which had been one of the bright spots in the economy, has declined in every month this year. The latest drop took place in July, when payrolls shrank by another 51,000 jobs. This latest decrease brings the year-to-date job loss to 463,000 jobs. As a result of this string of declines, there were 67,000 fewer jobs in July 2008 than last July. This paucity of employment growth and increase in the labor force has caused U.S. civilian unemployment to climb to 5.7%, which is a full percentage point higher than last year. Construction lost 22,000 jobs this July. It has shed 557,000 jobs since its September 2006 employment peak. Manufacturing lost

another 35,000 jobs, bringing its year-over-year decrease to 383,000 jobs. Layoffs in its temporary help services component caused professional and business services to shrink by 34,000 in July. Not all sectors suffered losses, however. Government payrolls expanded by 25,000 jobs in July, with all the growth coming from state and local governments. Federal government employment actually decreased slightly from June to July. Education/healthcare added 33,000 jobs in July, bringing its year-over-year increase to 368,000 jobs. As was mentioned above, the number of nonfarm jobs in July 2008 was slightly below the previous July's levels. This characteristic is expected to persist through late 2009. On an annual basis, U.S. nonfarm employment is forecast to stall this year and next, before growing 1.4% in 2010 and 1.8% in 2011. The simple arithmetic of stagnant job growth and increasing labor force points to increasing unemployment down the road. Specifically, the nation's unemployment rate is expected to peak at 6.1% in the second quarter of 2009 and hover near that level for almost a year. As the accompanying chart shows, this is above the rate consistent with full-employment.

**Housing:** The ailing U.S. housing market has not yet hit its bottom, but it may be getting closer. One promising statistic is existing home sales have remained near five million units for the last seven months. This is occurring because foreclosures are playing a greater role in the housing market than they ever have before. Banks are pricing homes to sell, which is driving prices down. The 10-City Case-Shiller Composite Index dropped 16.3% year-over-year in April, a record decline. But it was not the only measure showing how drastically prices have fallen. The 20-City Composite Index was down 15.3%, which was also a record. It remains to be seen, however, whether

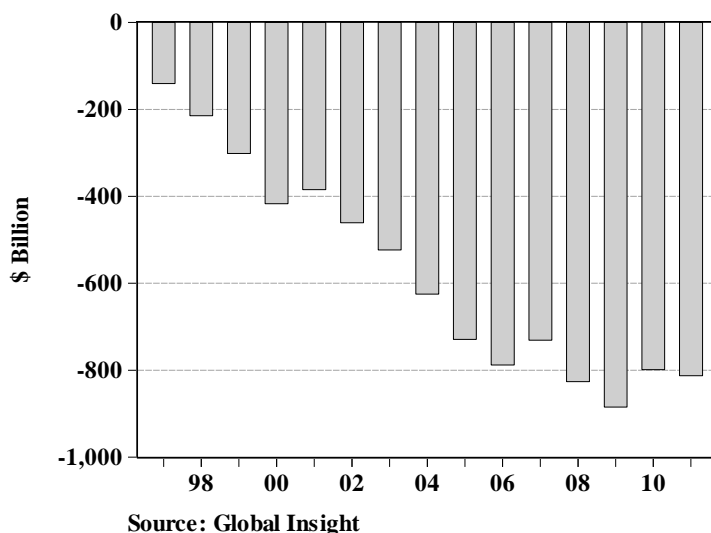
## U.S. Housing Starts



Source: Global Insight

existing home sales can work off the huge inventory overhang. Unfortunately, the new housing sector remains weak. New home sales have not done as well as existing home sales. In addition, single-family housing starts and permits are still falling. However, there is some reason for hope. The rate of decline in single-family starts and permits has slowed. In fact, the May 2008 construction report showed construction spending on single-family homes posted its second smallest drop in ten months. Going forward, the declines are expected to shrink, and housing should become a progressively smaller drag on real GDP growth. It is anticipated that the housing sector will cease to be a drag on the economy beginning in the second quarter of next year, which is two quarters after housing starts bottom out at 818,000 units. On an annual basis, U.S. housing starts are forecast to be 933,000 units in 2008, 1.01 million units in 2009, 1.43 million units in 2010, and 1.69 million units in 2011.

### U.S. Current Trade Deficit



**International:** The trade imbalance is expected to tip favorably toward the U.S. during the next couple of years. The improving nominal trade situation is hard to detect because rising oil prices inflate the import bill. At its worst in the end of this year, the nominal deficit will be only slightly better than at its peak between late 2005 and mid 2006. In the current forecast, the nominal deficit improves only after oil prices retreat. Specifically, nominal net exports go from \$708 billion in 2007 to \$831 billion in 2008, to \$837 billion in 2009, \$693 billion in 2010 and to \$680 billion in 2011. In order to get a more accurate picture of the situation the nominal trade results must be adjusted for inflation.

Making this important change shows the

trade situation improves more quickly than the nominal values lead us to believe. Instead of rising through 2009, real exports actually improve \$123 billion this year and another \$111 billion in 2009. However, real exports begin to lose ground after that year because revitalized consumer spending and stepped-up materials demand increase imports. Specifically, real imports accelerate from virtually no growth in 2008 and 2009 to over 6.0% growth in 2010 and 2011. The gap widens further in the out years because of slower export growth. On a current-account basis, the trade deficit is -\$827 billion this year, -\$885 billion next year, -\$799 billion in 2010, and -\$813 billion in 2011.

**Business Investment:** The next few quarters will be a struggle for real business investment. Real spending on equipment and software is forecast to decline in the second quarter of 2008 and grow slowly in its third quarter. An investment rebound is expected in the fourth quarter, as companies take advantage of the accelerated depreciation allowances that are part of this year's fiscal stimulus package. However, this rise will be followed by a spending drop that is payback for the binge in the fourth quarter of 2008. On an annual basis, real spending on equipment and software is expected to expand 1.7% this year and 0.6% next year. Its pace picks up noticeably beginning in 2010, and averages nearly 7.0% per year through 2011. Real transportation spending is forecast to drop nearly 10% this year and remain flat next year. Spending on industrial equipment faces an uphill challenge as manufacturers wind down their recent spending projects. As a result, inflation-adjusted spending on industrial equipment slides 4.9% in 2008 and 6.1% in 2009.

**Government:** Fiscal policy is expected to provide the economy with a quick-but-temporary boost. Last winter Congress passed and the President signed into law a stimulus package that is worth \$152 billion in fiscal 2008 (or 1.1% of GDP), of which \$107 billion is for households (via tax rebates) and \$45 billion is for businesses (almost all via 50% bonus depreciation). It is assumed that about three-quarters of the rebates arrived in the second quarter and the rest will be delivered in the following quarter. It is also assumed that 20% of the rebates are spent within three months, 40% within six months, and 50% within a year. Under these assumptions the biggest impact on spending comes in this year's third quarter. This forecast also assumes Congress will not allow all of the Bush administration's personal tax reductions to expire at the end of the decade. But tax burdens are expected to increase, nonetheless, either through the impact of the Alternative Minimum Tax or through some other type of tax reform that raises revenues. On the expenditure side, spending for the wars in Iraq and Afghanistan is expected to climb. Defense spending is expected to rise 9.8% in the current federal fiscal year and 5.9% in the following year. Overall federal outlays are forecast to increase 9.3% in 2008 and 5.7% in 2009. However, slower defense spending in 2010 and 2011 helps tame future overall spending. On a unified budget basis, the federal deficit is predicted to rise from -\$162 billion in 2007 to -\$412 billion in 2008, and to -\$497 billion in 2009. After that year it drops to -\$444 billion in 2010 and to -\$383 billion in 2011.